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ride the light

Qwest.

March 2, 2001

Chairman William A. Mundell
Commissioner Jim Irvin
Commissioner Marc Spitzer
Arizona Corporation Commission
1200 West Washington Street
Phoenix, AZ 85012

Re: Qwest Rate Case Proposed Settlement
Docket No. T- 01051B-99-0105

Dear Commissioners:

I am writing to express my disappointment and concern with Chairman Mundell's letter of March 1, 2001, proposing that the Settlement Agreement in the pending Qwest rate case not be considered at the March 7th Open Meeting. Qwest filed this rate case at the Commission's order on January 8, 1999. It has been pending for more than two years and the course proposed by the Chairman for additional hearings or settlement negotiations promises further delay in this matter with no end in sight. Any additional delay of this case will be a disservice to the parties who have labored long and hard to bring a fair and reasonable settlement before you. It will also harm the citizens of the State of Arizona by depriving them of the undoubted benefits they will receive as a result of this settlement. Qwest will have all of its witnesses available at the Open Meeting on March 7, 2001 to address the issues in Chairman Mundell's letter and any other questions the Commissioners may have.

Chairman Mundell asks for clarification in seven areas. All seven of these areas are clearly answered within the existing record. I will address each of these points in this letter and would welcome the opportunity to respond to them more fully at the March 7, 2001 Open Meeting.

1. The $42.9 million revenue requirement increase is fully supported by the evidence in this record and by the cost of service analyses undertaken by the parties. Proposed Order at 9. Staff witness Michael Brosch, Department of Defense witness Richard Lee and Qwest witness George Redding each testified that the settlement figure was reasonable based on the record in this case. Transcript of Proceedings, Vol. I, November 29, 2000 at 125-128 (Redding); Transcript of Proceedings, Vol. III, December 1, 2000, at 478-480 (Brosch); and Transcript of Proceedings, Vol. III, December 1, 2000, at 672-674 (Lee). Mr. Brosch testified that Staff had analyzed the adjustments proposed by each of the parties in advising Staff that this settlement was in the public interest. Transcript of Proceedings, Vol. III, December 1, 2000 at 479, 483-488, 506-507 (Brosch).

All of the parties had complete access to Qwest's cost of service studies and had ample opportunity over the twenty-two months between the filing of this case and the hearing on the settlement to analyze that testimony. The settlement amount is derived using Staff's fair value rate base, "the lowest of the three parties who submitted testimony on this issue," and Staff's rate of return. Proposed Order at 9; Transcript of Proceedings, Vol. III, December 1, 2000 at 478, 491-492 (Brosch). The revenue requirement increase and related rate design are derived from Staff's analysis of the cost of the services for which rates are adjusted in the settlement.

2. The fact that the test year is a 1999 test year does not mean that the settlement is out of date. A.C.C. R14-2-103(A)(3)(p) states that a test year is to be "the 1–year historical period used in determining rate base, operating income and rate of return. The end of the test year shall be the most recent practical date available prior to the filing." When this case was filed in January of 1999, the filing used a test year ending June 30, 1998. Testimony of George Redding, January 8, 1999 at 7. In May of 2000, Qwest updated the test year by filing completely new rate base and financial information for a test year ending December 31, 1999. Supplemental Testimony of George Redding, May 3, 2000 at 1-3. The test year is consistent with the Commission's rules and with the past practice of this Commission. To the extent that the test year fails to reflect growth in access lines and other revenue sources, it also fails to permit Qwest to recover a return on its investment made and an increase in expenses incurred after December 31, 1999.

3. The Depreciation rates used in Qwest's updated filing in May of 2000 are those approved by the Commission in Decision No. 62507. Transcript of Proceedings, Vol. I, November 29, 2000 at 141 (Redding). Qwest's replacement of plant in the future (as it becomes technologically obsolete) and its installation of new plant will be consistent with its testimony before the Commission in support of the approved depreciation rates. There is no appropriate correlation between depreciation rates and plant retirements; the focus should be on the correlation between modernization (investment) and depreciation. Rebuttal Testimony of Dennis Wu, August 21, 2000 at 3, 6-12; Rejoinder Testimony of Dennis Wu, September 19, 2000 at 3-7. The depreciation lives were set to be forward-looking and consistent with the lives of Qwest's competitors in Arizona. Id. Further, during the year 2000, Qwest booked $93 million in depreciation expense for which it will never obtain any recovery. Id.

4. The settlement agreement provides for adequate monitoring of Qwest's investment, service quality and financial results. As Chairman Mundell's letter recognizes, Staff has the ability to obtain from Qwest information sufficient to verify that Qwest has made the investment provided for in Decision No. 62672 and Decision No. 63268. The Service Quality Plan Tariff requires Qwest to make quarterly filings and pay annual fines, where appropriate, with respect to its service quality. Service Quality Plan Tariff, Section 2.6. Both the merger order and the settlement agreement have increased the fines Qwest will pay if it fails to meet those service quality standards. Proposed Order at 10-11; Decision No. 62672 at 11-12; Settlement Agreement at ¶ 5. Finally, the settlement agreement obligates Qwest to provide specific information to Staff concerning its financial performance during the term of the Price Cap Plan. Settlement Agreement,

Attachment A, Price Cap Plan at ¶ 2(b)(v) and ¶ 5. In addition, Staff is permitted to ask for any additional information it deems necessary to monitor Qwest's compliance with the Plan or to review the Plan at the end of its term. Settlement Agreement at ¶ 4; A.R.S. § 40-204.

5. The settlement agreement is based on an appropriate level of imputation for the directory publishing business. In 1985, the Commission and Mountain Bell entered into a settlement agreement whereby it was agreed that imputation would be based on the value of fees and services received by Mountain Bell for DEX and that the presumptive amount of that imputation would be $43 million. Transcript of Proceedings, Vol. IV, December 4, 2000, Exhibit Q-48. In January of 1995, the Commission entered a rate order imputing an amount greater than $43 million to U S WEST. That order was vacated by the Court of Appeals. Transcript of Proceedings, Vol. IV, December 4, 2000, Exhibit Q-49. As Mr. Brosch, Staff's witness testified at the hearing:

> The settlement agreement limiting imputation to approximately 43 million existed prior to the last litigated rate case in Arizona. I, as Staff's witness, recommended an imputation amount of approximately 60 million in that case, which the Commission did in fact approve, and then upon appeal, the Commission, in my understanding of the situation, was compelled to reduce the imputation to comply with the $43 million settlement agreement amount, and in fact ultimately allowed the company a surcharge to recover revenues not collected because of the Commission's acceptance of my recommended higher imputation amount in the last case. And all of that certainly bore on my view of the litigation risks surrounding the issue in the case.

Transcript of Proceedings, Vol. III, December 1, 2000 at 509-510.

6. The settlement fully reflects the sale of the rural exchanges to Citizens. In its May 2000 updated filing, Qwest deleted all revenues, expenses and investment related to the Citizens sale. Supplemental Testimony of George Redding, May 3, 2000, Exhibit GAR-S7G. The productivity factor referenced by Chairman Mundell consists of a 3.7% annual productivity adjustment, based on Staff's expert's review of Arizona specific productivity data for Qwest, and a consumer dividend unrelated to any demonstrable increase in productivity achieved or likely to be achieved by Qwest. The 3.7% productivity factor, even without the consumer dividend, is at the high end of the range of productivity factors adopted in the 42 states that have price cap plans. Transcript of Proceedings, Vol. III, December 1, 2000 at 616-619, 640-646; Rebuttal Testimony of Harry M. Shooshan III, November 20, 2000 at 10-11; Testimony of Harry M. Shooshan III, October 27, 2000 at 5, 10-11. Finally, the term of the Price Cap Plan has been reduced from 5 years to 3 years to permit the Commission to review whether any merger synergies or sale-related cost savings have in fact been achieved based on actual financial results of Qwest. Administrative Law Judge Rodda expressly

recognized that a review based on actual historic experience with the Price Cap Plan at the end of the three-year term would permit the Commission to adjust the productivity factor if Qwest enjoys greater productivity gains than it has in the past. Proposed Order at 10.

7. The proposed settlement fully complies with the Commission's obligation to assure that Qwest's rates are just and reasonable. Staff fully analyzed Qwest's cost of service, revenue streams and appropriate revenue requirements in concluding that the settlement was in the public interest. Supplemental Testimony of Michael L. Brosch, October 27, 2000 at 1-4. Further, the independent expert from the Department of Defense analyzed the settlement and testified that it was reasonable and in the public interest. Transcript of Proceedings, Vol. III, December 1, 2000 at 671-677 (Lee). The record in this matter is fully developed. The administrative law judge who conducted the hearing on this matter concluded that the parties had a full and fair opportunity to review the settlement and present their objections to it. Propose Order at 21-22. As Commissioner Spitzer observed in the public comment session in Tucson, there was a substantial record in this case from which the Commission could evaluate whether the revenue requirement figure contained in the settlement was just and reasonable. The Commission has an adequate evidentiary basis to evaluate whether this settlement is in the public interest. There is no need for further hearings or settlement negotiations.

This case has been pending for over two years. During that time, the consumers of this state have been deprived of the benefits that this settlement will bring them; the introduction of new, innovative, cutting edge-services in a timely fashion. Further, consumers will not reap the benefits of stable rates over the next three years, i.e., capped basic rates for local exchange service with the possibility of further decrease resulting from the productivity factor. The telecommunications industry in this state has changed drastically since the conclusion of Qwest's last rate case. The settlement and Price Cap Plan represent an initial recognition of that fact.

The settlement before the Commission is not different from numerous other settlements approved by the Commission in rate cases for telephone, electric, gas, water and sewer utilities. 42 other states have adopted some form of price cap regulation for incumbent telecommunications companies. This settlement brings regulation in Arizona in line with the great majority of states.

The process by which the settlement was reached was fair to all parties. The majority of the parties in the case support the settlement. It would denigrate the efforts of Staff and the other parties who support the settlement if this matter were taken off the agenda of the March 7th Open Meeting and the Commission did not consider the settlement on its merits.

Qwest stands ready to produce all of its witnesses at the March 7th Open Meeting and answer any questions the Commissioners may have concerning the settlement. We ask for the opportunity to reiterate our position at that open meeting and have the Commission approve or disapprove the settlement on the record that has been developed over two years in this case. There is no need for further hearings or further delay in this case.

Since I came to Arizona in August of 2000, Qwest has undertaken significant efforts to improve its service quality and to work with the Commission and its Staff to resolve issues. This settlement represents a significant effort by Staff and Qwest to resolve the rate case in a manner that is fair to the consumers of Arizona and to the Company. I urge you to bring this matter to a vote at the March 7th Open Meeting and to approve this settlement.

Sincerely,

Teresa Wahlert

Teresa A. Wahlert
Vice President – Arizona
Qwest Corporation

cc: All Parties of Record